The New Federal Acquisition Regulation Liability Requirements

Loss, Damage, Destruction, or Theft of Government Property in the Possession of Contractors-Part 2

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The views expressed herein are those of the author and do not necessarily reflect the views of the Defense Acquisition University or the Department of Defense.

Ahhhh, so you are back again. Wanted to know the answer to the question, huh?

In Part 1 of this article I addressed the Full risk of loss provision of the new Federal Acquisition Regulations (FAR) Government Property Clause found at 52.245-1(Alt. I). I then continued the analysis of the Limited risk of loss provisions under FAR 52.245-1(h).

I deliberately left you hanging without the answer to the question, "Can the Government hold the contractor liable given the 'Drunken Forklift operator' scenario?

Well, let's see!

Can the government prove willful misconduct? We would probably all say yes. Can the government prove lack of good faith? Again, we would all probably say yes.

Yet, in spite of this consensual agreement on these two items, the government cannot hold the contractor liable.

Why? Because we left out one critical factor. We must look at the clause again. FAR 52.245 1(h)(1)(ii) does state willful misconduct or lack of good faith, but on whose part? CONTRACTOR'S MANAGERIAL PERSONNEL. It is this definition that we must operationalize in our property administration and contract management environment. Not what we think it means but what it means in accordance with the FAR. We see the definition of contractor's managerial personnel at 52.245 1(h)(1)(ii). It states,

"Contractor's managerial personnel, in this clause, means the Contractor's directors, officers, managers, superintendents, or equivalent representatives who have supervision or direction of all or substantially all of the Contractor's business; all or substantially all of the Contractor's operation at any one plant or separate location; or a separate and complete major industrial operation."

It is here that we see that management, contractor's managerial personnel, is not just someone who has the title of manager but must also have the authority, the legitimate power to control the entire company or corporation. To put it simply, plainly and clearly we are talking about the Presidents, Vice Presidents, and the Directors of these companies. We must be very careful as to whom we apply this label of contractor managerial personnel. Some of you may still have some doubt in your mind as to whether this is correct. Well, the ASBCA comes running to our rescue again. In a landmark case, a seminal case for the field of government property, the ASBCA ruled on just this issue. In a case widely known as the Fairchild Hiller Case (ASBCA No. 14387. November 30, 1971) the contractor was tasked to perform inspection and repair of C 130 Aircraft. Unfortunately, a C 130 was destroyed by a fire caused by the usage of a highly flammable liquid in the cleaning process. The Air Force, having warned the contractor of numerous safety deficiencies, believed that there existed a "chasm between management actions and management assurances." Therefore, the Air Force attempted to hold the contractor liable.

The court, in reviewing the case, concluded that even though management might have been considered lax, they had not exhibited willful misconduct or lack of good faith and it was in fact negligence on the part of the operational personnel and mid level management. Again, we must be concerned with the definition of managerial personnel. It is simply "Top Management." It would appear then that it is virtually impossible to prove "willful misconduct or lack of good faith on the part of contractor's managerial personnel" unless the president of a company TELLS us he or she is going to purposefully destroy an item of government property and then sets about doing in front of us!

Well, maybe...and maybe not. We must go one step further, one section on in paragraph (h) to (1)(iii) which states:

"The Contracting Officer has, in writing, withdrawn the Government's assumption of risk for loss, damage, destruction, or theft, due to a determination under paragraph (g) of this

clause that the Contractor's property management practices are inadequate, and/or present an undue risk to the Government, and the Contractor failed to take timely corrective action."

Note the steps and the conclusions in this section. The notification must be provided IN WRITING. It is interesting to note that in the past version of the FAR enormous attention was paid to the details regarding HOW this letter was to be sent and to WHO this letter was to be sent. In the past version this letter was to be sent by certified mail –no longer a requirement – therefore, the government loses its ability to "prove" the ultimate delivery of the notification. Secondly, there is no longer any direction as to WHOM the letter is to go to. Conceivably, it may go to the company property manager, most likely to the company contracts manager (Since that is the company representative with whom most government COs deal). It is highly unlikely that it will go to contractor managerial personnel as defined in the clause as there is no contractual requirement to do so.

Lastly, this letter notifies the company of the government's withdrawal of their assumption of risk for LDD&T due to a determination that the contractor's property management practices are inadequate and/or present an undue risk to the government.

What does this provide the government? The contractor is now LIABLE for all LDD&T. It would appear that the government's withdrawal of its assumption of risk due to the inadequate contractor's property management system, though not meant to be punitive in nature, does serve as a very powerful and potent motivator. I am sure that if any of you have dealt with a contractor whose system has been found to be inadequate, you know how quickly top management will start to pay attention to the area of government property. It is with this withdrawal of assumption of risk that the contractor's liability essentially reverts to the "ALL" provisions of the previously discussed clause.

This action, the written notice of the government's rescission of its assumption of risk makes the contractor liable for ALL loss, damage or destruction of government property regardless of its cause. Upon receipt of the written notice of the government withdrawing its assumption of risk — the contractor is liable for ALL loss, damage or destruction of government property.

Ahhh, but in life there are always those "buts and excepts." It just so happens that this is the case with these liability provisions as well. Though the government is presumed to have that "conclusive proof," there are available two, if I may call them such, escape mechanisms. The government is not unreasonable and therefore realizes that there may be mitigating circumstances surrounding those losses of government property. If you notice, I did not complete all of paragraph (g)(1)(iii). I left off the portion that states:

"If the Contractor can establish by clear and convincing evidence that the loss, damage, destruction, or theft of Government property occurred while the Contractor had adequate property management practices or the loss, damage, destruction, or theft of Government property did not result from the contractor's failure to maintain adequate property management practices, the Contractor shall not be held liable."

Bear with me as I am going to discuss to two escape mechanisms in reverse order. The latter states:

"Occurred while the contractor had adequate property management practices…."

While previously the government bore the responsibility to prove the contractor liable, for any LDD&T, that responsibility is now shifted to the contractor to PROVE that it is NOT liable due to circumstances surrounding the LDD&T. In this case, when the loss actually occurred, i.e., the time at which it occurred. When did the LDD&T occur? If the contractor can offer clear and convincing evidence that the incident occurred while an adequate system was in force, the contractor may be granted relief of responsibility. The former, which is a little more complex, states:

"(A) Did not result from the Contractor's failure to maintain adequate property management practices…."

It is here that the contractor may attempt to provide that clear and convincing evidence that there was no causal relationship between the LDD&T and the contractor's inadequate practices. Considering that a contractor's PCS is evaluated in fifteen functions or processes, we have to consider which functions were unsatisfactory or deficient and remained uncorrected so as to lead to said determination of inadequacy. If the contractor can prove that there was no causal relationship, and let's use the legal word here —no nexus, between the LDD&T and the reason for the government withdrawal of its assumption of risk, the contractor may again be granted relief of responsibility.

A simplistic example of this would be when a contractor is unsatisfactory or deficient in the category of subcontractor control. This deficiency leads to the contractor's PCS being determined to be inadequate. At some time after the letter by the CO a sub contractor reports the loss of some government owned Special Tooling (Note the actual loss occurred after the letter, not just the reporting of the loss). It would appear that there is a connection, a nexus, that causal relationship between the disapproval of the PCS and the loss. A second example would be if a contractor's PCS was rated inadequate due to deficiencies in all categories. All fifteen functions are unsatisfactory and the contractor refuses

to take any action to correct them. The government withdraws its assumption of risk due to this inadequacy. A commercial aircraft flying overhead crashes into the contractor's facility destroying all of the government property. The contractor could easily claim that there was no way having an adequate PCS/PMS would have prevented that plane from crashing. There was no relationship, no nexus between the plane crashing and the conditions leading to the contractor's inadequate property management practices.

Notice that liability is a difficult but not impossible area to discuss.

Previously in the "old" versions of the FAR and its predecessor the Defense Acquisition Regulations (DAR) there were multiple versions of liability: liability under Fixed Price contracts, liability under Fixed Price Negotiated contracts, liability under Facilities contracts, and liability under Cost Reimbursement contracts, to name a few. But if we were to carefully analyze all of these clauses we could discover that ultimately there were two forms of liability – FULL risk of loss and LIMITED risk of loss.

Why?

Why does the government take this stand? Why not either hold the contractor liable for everything or have them carry insurance for everything? It has to do with one simple factor: COST. Under that fixed price contract whose price is based upon adequate competition, we, the government, assume that this is the lowest price available. Therefore, even though this price may contain monies for insurance, it is the contractor's determination as to how much insurance to carry. It is the contractor's decision and responsibility to assume the risk. However, under the Fixed Price Negotiated and Cost Reimbursement type contracts this cost can be isolated and excluded from the contract price. More importantly, we, the government, act as a self-insurer. Consider a hypothetical situation for a moment. Assume that the government has $100 billion worth of government property in the hands of the contractors. A fairly accurate rough order of magnitude for the Department of Defense. If today insurance costs were running between 4 and 5% for a face value policy the government, indirectly through all of its contracts, would be spending between 4 and 5 billion dollars a year for insurance.[1] Instead they prohibit the contractor from carrying insurance and charging the government for those costs and the government acts as a self insurer not spending that $4 to 5 billion per year. Again hypothetically, if the contractors lost 1/2 of 1% of the government property in their possession in a year the loss would total $500,000 million. This may appear to be mind boggling to us but consider that we are dealing with very large figures here. What is more important is a comparison and offset between what would have been spent for the insurance ($4 to 5 billion) versus the loss ($500,000 million) yielding a difference or savings of $3.5 to $4.5 billion dollars a year. If you think this is outlandish, consider for a moment that probably each and every one of you does the same thing every day. "What?" you say. "I wouldn't do something like that." Are you sure? If you own a car, you carry insurance on that car, hopefully. If you were to get into an accident, a fender bender, your insurance company would pay for the repair. The entire repair? Or is there something, some part of the repair price, they may not give you such as the deductible for 100 dollars or 250 or 500 dollars that you carry. What you are doing is acting as a partial self-insurer. The reason you do this is because it lowers your insurance premium. It is cheaper for you to carry that risk with the hope and the anticipation that you WILL be careful and that you WILL NOT have an accident. The government takes the same position. They believe that the contractor WILL be careful and that they WILL NOT lose damage or destroy any government property. It is a logical thought process.

Subcontractor Liability

We have covered the Prime contractor's liability – but what about if the Prime provides Government property, either GFP or where the subcontractor is authorized to acquire property that becomes CAP. Do the same rules apply? Well, in that ever present response, "It depends!" Let me walk you through the intent of the new FAR subcontractor concept.

Deletion of the Advance Approval Requirement

The most critical change in the clause was NOT the liability provisions, but rather the DELETION of the requirement for the Prime contractor to come in and ask, "Mother, may I?" Specifically, under the OLD GP clause of FAR 52.245-5 or FAR 52.245-2(Alt. I) the contractor was required to come in PRIOR to awarding the subcontract and request from the Government the ability, the permission to flow down the LIMITED RISK OF LOSS provision of the GP clause. THIS REQUIREMENT HAS BEEN DELETED! Contractors no longer need to ask, "Mother, may I."

Now, does that mean that the prime contractor may automatically flow down the Limited Risk of Loss provision from their contract to EVERY Subcontract/ Subcontractor when GP is provided to them by the Prime? NO! That is NOT what the clause says. I have heard a number of presentations where this has been stated, as well as a number of texts where this has been written. I am sorry to say that they are wrong. Please do not take my word for it – read the clause! We see references to subcontractors in three cites:

52.245-1(b)(2) which states, *"This requirement applies to all Government property under the Contractor's accountability, stewardship, possession or control, including its vendors or subcontractors (see paragraph (f)(1)(v) of this clause)."*

52,245-1(b)(3) states, *"The Contractor shall include the requirements of this clause in all subcontracts under which Government property is acquired or furnished for subcontract performance."*

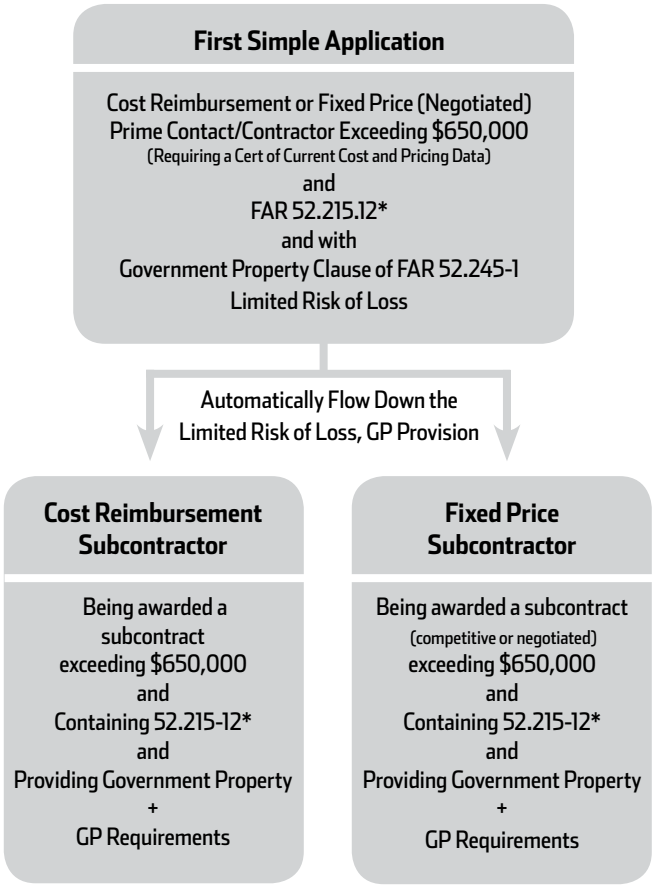
This is the clausal extract that has caused some confusion – why? Because it is believed that you must flow down the CLAUSE – including the liability provision within the clause. Well, it DOES NOT require that the Prime flow down the CLAUSE – rather it directs, it requires the Prime to flow down the REQUIREMENTS of the clause. No, I am not mincing words here. Flowing down the clause in toto is inappropriate because there are REQUIREMENTS in the clause that are "situational." And that brings us to the third reference in the clause to subcontractors.

52.245-1(f) under Contractor plans and systems discusses subcontractor control as a process and outcomes under paragraph (v). Paragraph (v)(A) states, *"The Contractor shall award subcontracts that clearly identify assets to be provided and shall ensure appropriate flow down (Emphasis added) of contract terms and conditions (e.g., extent of liability (Emphasis added) for loss, damage, destruction or theft of Government property)."*

Ahhh, so embedded in the clause is the requirement to flow down the APPROPRIATE liability provision. It would appear that the government wants the contractor to act in a reasonable, prudent fashion in determining WHEN it is appropriate to flow down the Limited risk of loss provision vis-à-vis the Full risk of loss provision.

"Wait a minute Doug, how do I know when to do which?" Glad that you asked! Let me give you some general rules:

Rule # 1: If the prime is required to use the clause at FAR 52.215-12 in its subcontracts – and GP will be provided – then the contractor may AUTOMATICALLY flow down the Limited Risk of Loss provision. FAR 52.215-12 is entitled Subcontractor Cost and Pricing Data and is driven by the requirement of FAR 15.408 (d) which routes you back to FAR 15.403-4 which is driven by statute, 10 USC 2306a and 41 USC 254b. So you all understand that right? Let me try and make it easier for you. By obtaining a certificate of current cost and pricing data the Government can ensure that there are no charges for insurance of government property. Remember, we just talked about insurance? The requirement for cost and pricing data is set at the contract level of $650,000 for any NEGOTIATED contract (Meaning either Fixed Price or Cost Reimbursement), and extends down to subcontractors.[2] The structure of the certificate is set forth in FAR 15.406-2. Here is a chart explaining THIS application:

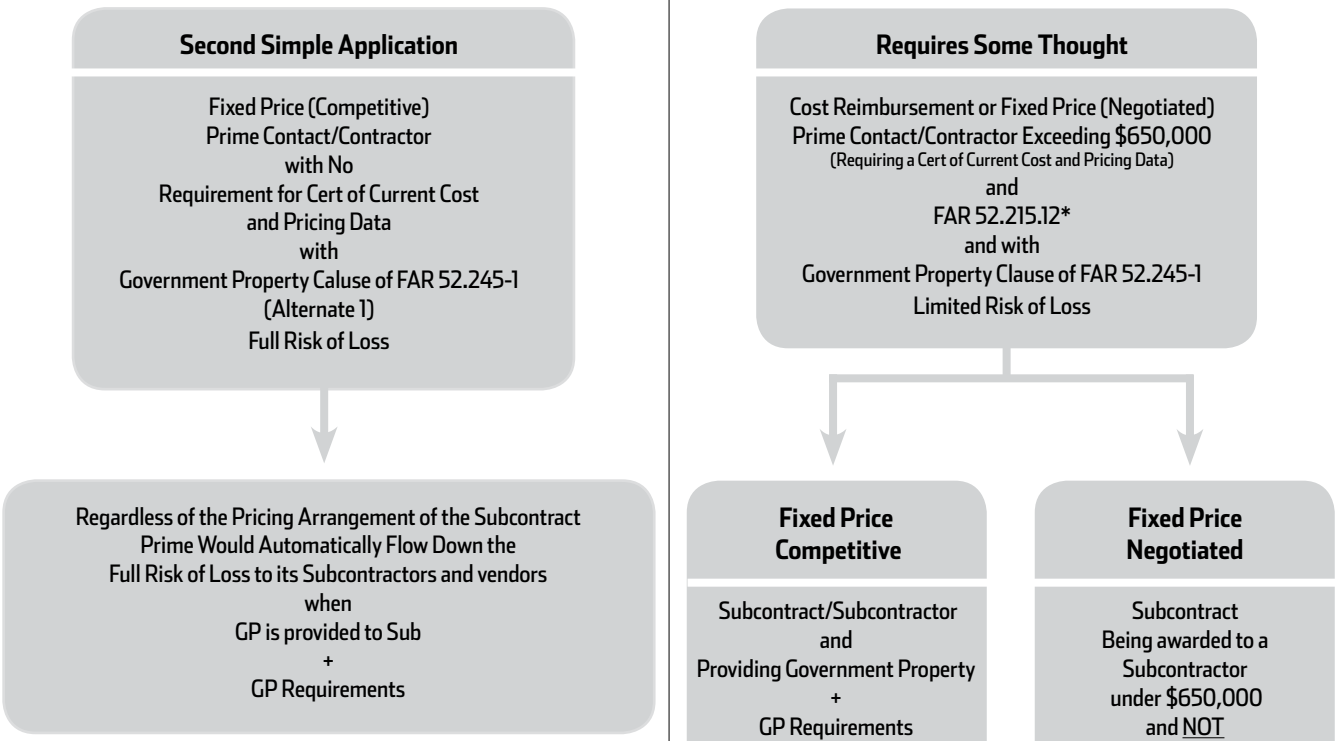


*** Note:** There are exceptions at 15.403-1 where the clause is not required.

Notice, that there is requirement for the Prime to ask the Government's permission – rather, AUTOMATICALLY, under these types of PRIME CONTRACTS with these types of SUBCONTRACTS with these CONDITIONS APPLIED this action may be performed/accomplished.

In the second scenario we have a FIXED PRICE COMPETITIVE contract with the Prime and this contract contains the FULL RISK OF LOSS provision. In this situation the prime is without recourse – it MUST flow down the FULL risk of loss.[3] Here is THAT scenario with the conditions applied:

O.k., one last scenario – and here is where it is going to require some thought. We have either a cost reimbursement type contract or a fixed price negotiated contract exceeding $650,000 and containing FAR 52.215-12 and it has Government property, either furnished or acquired, being provided to a subcontractor. But, the Government property may be a fairly large amount



– dollar wise – say two or three million dollars worth of Government property! Requiring the subcontractor to assume the risk of loss would be an expensive proposition. Therefore, if the Prime can get the sub to agree that it has not and will not include any charge or reserve for insurance, including self-insurance, it would certainly behoove the prime contractor and the subcontractor to flow down the limited risk of loss as an APPROPRIATE provision.

From a subcontractor liability perspective a number of things have changed! First, that prime contractors no longer need to ask the Government's permission to flow down the limited risk of loss provision of the Government Property clause. Second, prime contractors have now been tasked to determine WHEN it is appropriate to flow down the limited risk of loss provision. The above discussion and charts were meant as a decision tree in enabling contractor and Government representatives in making these decisions.

Contractor Property Manager Responsibilities

The contractor's responsibility for reporting LDD&T of government property is not found in the liability provisions of the clause but rather is found in the "Process" portion of the clause that discusses the requirements for the contractor plans and systems – paragraph (f) of 52.245-1. Under paragraph (f)(1)(vi) entitled reports paragraphs (A) and (B) provide the contractor guidance regarding the reporting of LDD&T.

Paragraph (A) states,

"Loss, damage, destruction, and theft. Unless otherwise directed by the Property Administrator, the Contractor shall investigate and promptly furnish to the Property Administrator, a written narrative of all incidents of loss, damage, destruction, or theft, as soon as the facts become known or when requested by the Government."

Quite simply contractors are required to report all incidents of LDD&T unless the PA through the contractor's property management system and practices has agreed to another process, e.g., compiling LDD&Ts

for periodic reporting where individual reporting would be prohibitively expensive – such as normal low rate losses of material.

What information is required to be reported? Paragraph (B) requires,

(B) Such reports shall, at a minimum, contain the following information:

1) Date of incident (if known).
2) The name, commercial description, manufacturer, model number, and National Stock Number (if applicable).
3) Quantity.
4) Unique Item Identifier (if available).
5) Accountable Contract number.
6) A statement indicating current or future need.
7) Acquisition cost, or if applicable, estimated scrap proceeds, estimated repair or replacement costs.
8) All known interests in commingled property of which the government property is a part.
9) Cause and corrective action taken or to be taken to prevent recurrence.
10) A statement that the government will receive any reimbursement covering the loss, damage, destruction, or theft, in the event the contractor was or will be reimbursed or compensated.
11) Copies of all supporting documentation.
12) Last known location.
13) A statement that the property did or did not contain sensitive or hazardous material, and if so, that the appropriate agencies were notified."

Voluntary Consensus Standards and LDD&T

It would appear to be a prudent time to address the requirements of the GP Clause and the new CONTRACTUAL requirement for contractors in possession of government property to use either Voluntary Consensus Standards (VCS) or Industry Leading Practices (ILP) in their management of government property.

ASTM International has a published VCS on liability. It is ASTM E-2131-01.[4] Though it is entitled "Practice for Assessing Loss, Damage, or Destruction of Property," it could better be described as a process for REPORTING Loss, Damage, or Destruction of Property and determining Loss Ratios. It does NOT address WHO is liable nor HOW MUCH an entity may be held liable. I find the reporting requirements excellent, in that they mirror the clausal requirements discussed earlier. I find the ratios very useful tools in assessing the adequacy of a property management system – at least in regard to the issue of Loss, Damage, or Destruction. But, government and industry employees need to be extremely careful with misinterpreting the VCS – it DOES NOT overrule the contractually imposed LIABILITY concept, i.e., who is liable and for how much are they liable. These concepts are NOT addressed in the VCS. The other aspect of the VCS that I find to be excellent is the issue of timeliness of reporting. Under paragraph 5 entitled "Procedure," there are VERY SPECIFIC TIMEFRAMES for the various reportings that must take place for an instance of Loss, Damage, or Destruction.

One other note in regard to the Loss Ratios set forth in the E-2131-01 VCS is in regard to efficiency of the contractor's PCS/PMS. Though this ratio may not directly impact the contractor's liability – it may, and SHOULD be used to assist in evaluating the efficacy of the contractor's PCS/PMS – and the application of risk management principles in determining frequency of audit performed either by the contractor's internal audit function or the government's audits done by the Property Administrator.

Government Property Administrator Responsibilites

Taking this information it is now in the PA's hands to reach a valid and supportable conclusion using their knowledge of the policy and clausal liability requirements, analyzing the contractor provided information, as well as performing their own investigation.

The Government PAs take their lead in processing the report of L, D, & D from the DoD Property Manual, Chapter 2, Section E.4 entitled Liability for Loss, Damage, Destruction or Theft of Government Property. Paragraph (d) states:

"It is the PA's responsibility to investigate the circumstances of LD&D of Government property and review the risk of loss and other contract provisions to determine which party assumes the risk of loss. When the Government assumes the risk of loss, investigations, in some circumstances, may be limited to verifying whether the contractor's report of LD&D is accurate. Extensive investigations should only be performed when dollar amounts, nature of the property, and circumstances of the incident warrant it. The assistance of other CAO technical personnel should be requested when appropriate."

There should be no room for feelings as this area is far too critical to be based upon anything other than the known facts of the occurrence. As some instances of LDD&T may involve highly technical aspects, it would behoove the PA to consult with other technical and legal specialists. We as PAs must not lose sight of the team alignment of the Contract Management Function.

"c. Risk of Loss Assumed by the Government. If authorized through the PA's Certificate of Appointment, the PA may take direct action as described below if the government has assumed the risk of loss. The contractor must identify the circumstances that led to the incident, and the provisions under the contract through which risk of loss was assumed. If the PA determines that the LD&D of government property constitutes a risk assumed by the government, the PA shall notify the contractor in writing, that the risk of loss is the responsibility of the government. A copy of the documentation and notification to the contractor shall be retained in the Contract Property Control Data File for the contract. An informational copy shall be provided to the CO. Additional reporting may be prescribed by agencies."

Here is where we see one of the Government PA's authorities. Though the Government PA has many tasks to perform, many of them are responsibilities connoting no authority. This task, granting relief of responsibility, is an authority that comes from their Certificate of Appointment delineating their authorities granted by the Contract Administration Office. If the PA determines that this loss cannot be presumed to be one of those that we said the contractor SHALL be liable for under either FAR 52.245 1 (h) contractor liability for government property, or FAR 52.245 1 Alternate I (h) Risk of Loss, the PA shall grant the contractor relief of responsibility and so notify the contractor.

It is important to note that the PA does NOT have the authority to HOLD the contractor liable. That is an action reserved for the Contracting Officer, more specifically, the Administrative Contracting Officer (ACO). The DoD Property Manual Chapter 4.E states:

"If the property administrator concludes that the contractor should be liable for the loss, damage, destruction, or unreasonable consumption of government property, he shall forward the complete file with his conclusions and recommendations to the administrative contracting officer for review and determination...."

It is the ACO's responsibility to review the file on this liability action and make a final determination. As the ACO is responsible for the financial well being of a contractor, and the holding of a contractor liable may affect the contractor financially, this would appear to be a prudent posture for the government to take. In addition, the ACO would be the only one who could withhold funds from the contractor if this were the methods utilized to recover the cost of the lost, damaged or destroyed government property. Once a decision is made the ACO will act in accordance with the DoD Property Manual, Chapter 2.E.6 which states:

"A copy of the CO's determination shall be furnished to the contractor, to the PA, and a copy shall be retained in the files of the CO. The PA's copy shall be filed in the Contract Property Control Data File for the contract when all pertinent actions, such as compensation to the government or repair or replacement of the property, have been completed. In the event that the contractor acknowledges liability, the PA will notify the CO in writing requesting a decision as to course of action required for equitable settlement."

Summary

The risk of loss provisions for government property in the possession of contractors have stood the test of time in their application, economy and efficiency. I do not need to tell you that the issue of liability and the actions required to report, support and resolve any instance of loss, damage or destruction of government property are complex and lengthy. Philosophically, one could not be faulted for saying something as patronizing and pedantic as it is in the contractor's best interest to control and protect government property in such a manner so as to preclude any of the above from happening. Unfortunately, or fortunately, whichever the case may be, we are human beings who have accidents and damage things, who slip up and lose things and who, through mishaps, destroy things. The government is not unreasonable in its demands that a contractor properly cares and protect its property. One would hope that we may all see this through the application of the various risk of loss provisions. It does make it incumbent upon us, both government and contractor personnel, to strive for that degree of protection where any form of loss, damage or destruction to the government's assets are minimized. We, as Property Administrators, must show this concern for property both within the government as well as within the contractor world to exhibit our belief in our profession the profession of Property Management! ■

Endnotes

[1] Please note that the 4-5% figure has increased dramatically since the occurrence of 9-11. As such the government savings as a self insurer undoubtedly would have increased.

[2] The discussion of the certificate of cost and pricing data and its requirements can be voluminous and therefore I cannot address all of the exceptions in this paper. I will have to leave that for another day of writing – unless one of YOU would like to do so?

[3] I have seen some discussion where a Cost Reimbursement type subcontract is awarded under a Fixed Price Competitive Prime contract. I am sorry to have to disagree with this construct – that situation would violate practically every basic rule of contracting/purchasing and would be a TRUE Aberration!

[4] Please note that this VCS is currently undergoing review and revision. This VCS can be obtained from http://www.astm.org.